Navigating the Pandemonium Raised by the Pandemic: Risk Mitigation in M&A

Article By
Curtis R. Hearn
Daniella G. Silberstein
Robert G. Kenedy
Elisabeth LeBlanc
Jones Walker LLP
Client Alert

- Coronavirus News
- Mergers & Acquisitions
- Corporate & Business Organizations
- All Federal

Monday, March 30, 2020

An important negotiating point between buyers and sellers of a business is whether to include within the acquisition agreement a “Material Adverse Change” (MAC) or “Material Adverse Effect” (MAE) related closing condition. For simplicity’s sake, we will use the term MAC to refer to both MAC and MAE.

Use of MAC Clauses

MAC clauses permit the buyer to void the transaction if, prior to the closing date, a material adverse development occurs that affects (or is reasonably likely to affect) the balance sheet, the results of operations or the business of the target company. Even in transactions in which the buyer does not prevail in including a standalone MAC closing condition, the transaction agreement frequently includes an absence of changes (or “no MAC”) representation that is brought down to the closing, along with a general representation and warranty “bring-down” closing condition that may be qualified by a MAC standard.
Pandemics and the MAC Clause

The coronavirus (COVID-19) pandemic has caused many companies and industries to experience widespread and severe disruptions to their operations, with some businesses facing material risks to their longer-term prospects. Given these developments, this is an opportune time to review MAC clauses for transactions that have signed but not yet closed, and to give special consideration to the risks presented by pandemics in negotiating and drafting MAC clauses for deals to come. In particular, this pandemic shows in high relief the danger of the carve-outs that are often included in the definition of a MAC. There is no doubt that this pandemic has had, and is continuing to have, an unprecedented material adverse effect on many businesses that no one could have anticipated, and would normally meet all the necessary elements of a MAC under Delaware case law. However, the effect of the carve-outs used in many acquisition agreements is to leave the buyer bearing the brunt of the risks associated with the pandemic.

Elements of a Material Adverse Change

The case law in Delaware, where many US mergers and acquisitions (M&A) disputes are litigated, sets a very high bar for buyers trying to establish that a MAC has occurred. The courts have made it clear that they will consider a variety of factors in determining whether a MAC has occurred, including whether (i) the event was unforeseen and unforeseeable, (ii) the change was material, (iii) the event was unique to the target company, and (iv) the impact on the business or the company is expected to be a temporary blip or a more permanent impairment (“years rather than months”\(^\text{1}\)). This is a difficult challenge to meet, because at the time the question is presented, the long-range impact of the intervening event might be very difficult to assess. Further, when the intervening event is the spread of a pandemic, it is rarely possible to prove a unique or disproportionate impact on the target company compared with other companies operating in the same industry, as required under many MAC definitions. Government responses to the pandemic, whether they are negative to the business (e.g., mandatory shutdowns) or positive to the business (e.g., bailouts), may also need to be considered in the fact-intensive analysis of whether a MAC has occurred.

Rethinking and Retooling

So, what is the best way to address a pandemic — or for that matter, any other cataclysmic risk — if you are a buyer (or a seller) and it is an unwanted risk (and therefore one that you want to shift to the other side)? The best way to achieve this goal, and indeed the only certain way, is to address the issue specifically in the contract rather than rely on a MAC clause. If you are a buyer, and you want the agreement to be clear that the occurrence of a pandemic will give you the right to void the contract, then spell that out in the contract by making it an express condition to closing. If you are a seller, and you don’t want to retain the risk of an intervening pandemic short-circuiting the deal, spell that out within the exceptions to the MAC definition in the transaction agreement. If the parties wish to include a purchase price adjustment mechanism, specific pre-closing covenants, or any other terms and conditions that are intended to address adverse conditions that may arise from a pandemic, they can (and should) spell these out explicitly in those sections of
the agreement. Otherwise, both parties will have a contractual risk that comes from uncertainty or contract ambiguity.

Several recent, large M&A transactions executed in February 2020 specifically addressed the coronavirus outbreak in their MAC definitions (either by referencing COVID-19 by name or by generally referencing pandemics declared by the World Health Organization). In such transaction agreements, the MAC definition excluded pandemics, but provided an exception to the exclusion if the pandemic had a disproportionate material adverse effect on the target company compared to other companies in the target’s industry. Whether or not the current pandemic will have a disproportionate material adverse effect on a target company is likely industry-specific. For example, one can easily envision a situation in which a target company owns a hotel or restaurant business and its footprint relative to its competitors is concentrated in geographic areas disproportionately and adversely affected by the current pandemic.

Beyond considering appropriate revisions to the MAC definition to specifically address pandemics, buyers may want to think more broadly about their general approach to risk allocation during the period between signing and closing. Up until now, when a MAC-related closing condition has been included in a purchase agreement, the working assumption has been that the buyer would assume most risks relating to the business that arise between signing and closing, unless they rise to such a level as to result in a MAC (which, as noted above, is a very high threshold and one that is not likely to be reached as a result of widespread events that are not company-specific). However, once the current COVID-19 crisis begins to wane, buyers may think more carefully about MAC clauses and other contractual provisions that allocate risk between the parties, and consider asserting more forcefully that sellers retain risks arising from broad-based risks that substantially impair an entire industry or market.

One lesson definitely seems worth learning from recent events: If anything has been demonstrated by the COVID-19 virus, it is that events are only unthinknable until they actually happen, at which time they become obvious. Pay attention to the language in the MAC clause. Think through the ramifications of the definition along with all of its exceptions. Don’t be in a hurry to accept an argument that “you are worrying about something that will never happen.” It is important for a company contemplating an M&A transaction to assess these types of risks and to consider with whom the risk should reside. If a party accepts a risk, so be it. But no party should take without fully understanding that risk that it was taking.


© 2020 Jones Walker LLP